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Mr Dick Warburton
Chairman
The Board of Taxation
c/- the Treasury
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Email: taxboard@treasury.gov.au

Dear Sir

Review of Employee Share Schemes

Following the Board of Taxation's (**Board**) request for submissions regarding the taxation of employee share schemes, the Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to provide comments for the Board's consideration. The comments focus on:

- how best to determine the market value of employee share scheme securities; and
- whether shares and rights under an employee share scheme that are provided by start-up, research and development and speculative-type companies should be subject to separate tax deferral arrangements outside of those proposed by the Policy Statement.

1. Market Value of Employee Share Scheme (ESS) Interests

In the Taxation Institute's submissions to Treasury regarding the taxation of employee share schemes dated 26 May and 11 June 2009 (copies attached), the Taxation Institute indicated that it was in favour of retaining the previous approach to valuations in the absence of empirical evidence establishing that the approach resulted in over and undervaluations.

Since the Taxation Institute's submissions, the Exposure Draft legislation on employee share schemes was released on 14 August. The Exposure Draft legislation provides for the use of general principles of market value for valuing employee share scheme interests and the optional use of an alternative formula based valuation method in respect of unlisted rights.

The Taxation Institute's comments on the valuation proposals in the Exposure Draft are set out below.

The market value of an asset can rarely be determined in absolute terms. Any valuation obtained is based on a number of assumptions and merely represents an estimate of the value. Ultimately, the actual value can only be determined at a point in time by the price determined in an actual exchange between buyer and seller.

The Exposure Draft legislation for Division 83A of the *Income Tax Assessment Act 1997* uses the general principle for market value when determining the assessable income in respect of a grant of shares. In respect of unlisted rights, the valuation rules as currently outlined in the draft Regulations state that the market value of unlisted rights is either the market value according to ordinary concepts or the value as determined by the use of the tables contained in the draft Regulations. These tables are the same as previously contained in Division 13A of the *Income Tax Assessment Act 1936*.

As a general comment, and subject to the specific comments below, it is the Taxation Institute's view that the use of the ordinary meaning of "market value" is a positive change. The Taxation Institute recommends that the Board retains the use of ordinary market value, but provides further specific "safe harbour" valuation

provisions where the ordinary market value may be difficult or costly to ascertain. This would provide certainty to employees in meeting their tax obligations and reduce compliance costs for employers in meeting their new reporting and TFN withholding obligations (which require the ascertainment of market value).

The application of market value can lead to difficulties in respect of certain equity instruments. To overcome these difficulties, the Taxation Institute has set out comments regarding potential safe harbour rules below based on the most common types of equity instruments granted under employee share schemes.

Listed Shares

Previously under the provisions of Division 13A, the market value of listed shares was prescriptively defined as the volume weighted average price (**VWAP**) for the 5 days up to an including the date of grant.

This prescriptive definition often led to administrative difficulties as companies struggled to acquire shares at this value. Often, share plan administrators would require the plan rules to state that the market value of the shares would be the value acquired on market which then would not be consistent with the value prescribed by Division 13A.

The Taxation Institute welcomes the change to the use of the general concept of market value in determining the assessable income associated with the grant of listed shares. In the Taxation Institute's view, this allows flexibility and simplifies taxpayer compliance.

However, the Taxation Institute recommends that a safe harbour provision be included so that the market value of a listed share is either the market value according to ordinary concepts or the value under the safe harbour provisions. An appropriate safe harbour could include the following:

- Where shares are acquired on market and immediately granted/allocated to taxpayers, the market value is the purchase price; and
- Where shares were issued by the company or acquired on market but held in trust until later allocation to the taxpayer, the market value is the VWAP determined on the date of grant (with a caveat to avoid abuse).

Unlisted Shares

The position regarding unlisted shares is more complicated. The previous provisions of Division 13A required that in order to determine the market value of an unlisted share, the employer had to either obtain a written valuation report by an independent registered company auditor, or obtain approval from the Commissioner of an alternative valuation method.

The Exposure Draft removes this requirement and replaces it with market value according to ordinary concepts. Again, this change is welcomed by the Taxation Institute.

Unlisted shares will still require a formal valuation. However, given the cost associated with corporate valuations, the Taxation Institute considers that a safe harbour should be provided to taxpayers (particularly those granted shares or rights by small and medium enterprises (**SMEs**)) so that they have a lower cost alternative.

Further, given that the termination of employment is currently still a taxing point, requiring companies (or the taxpayer) to obtain a formal valuation each time an employee ceases employment, this will result in a significant administrative burden. It is likely that this will result in some private companies not issuing shares to employees or not allowing those shares to be held post employment.

The Taxation Institute recommends that the Board advises the Government to formalise a safe harbour valuation methodology to assist in reducing the overall costs associated with the grant of shares and options in unlisted companies.

The safe harbour valuation methodology(s) should be reliable, not overly complex for taxpayers to use and not open to manipulation. It could consist of a choice of specific valuation methodologies such as:

- Net tangible assets;
- Profit (EBIT) multiple; or

- Discounted cash flow.

Taxpayers would be required to use the chosen valuation methodology consistently. It would be appropriate for the Government to consider a basis under which the taxpayer could change the valuation method.

Unlisted Rights

The Exposure Draft legislation allows taxpayers to value unlisted rights either according to ordinary concepts or by using the tables previously contained in Division 13A.

The Taxation Institute welcomes the flexibility provided by this choice and is of the view that in the absence of any empirical data showing that the tables consistently over or under value unlisted rights, the choice as outlined in the Exposure Draft should be retained.

The Taxation Institute considers that, provided the recommended safe harbour provisions are implemented in relation to valuing shares, no further change needs to be made to the valuation methodology for unlisted rights.

2. Separate Tax Arrangements for R&D and Speculative Type Companies

While the Taxation Institute understands that the proposed legislative changes could disadvantage certain R&D and speculative type companies, the Taxation Institute does not recommend a different tax regime for these entities (ie these entities should be subject to Division 83A just as all other entities will be).

That said, the Taxation Institute would support valuation concessions being introduced to assist small to medium unlisted companies being able to satisfy the valuation requirements in a cost effective manner. Eligibility for the concessions would need to be restricted (eg based on turnover). Further, integrity measures would also be required.

3. Other issues

The Taxation Institute is aware that the issue of the timing of the deferred taxing point in respect of employee share options is outside the terms of reference of the Board's review. However, the Taxation Institute believes that it is unreasonable to impose tax on an option notwithstanding the taxpayer may never realise value, and to subsequently deny the taxpayer a refund where tax has been paid and the option is never exercised because it is out of the money. Therefore, the Taxation Institute would strongly recommend that the Board advises the Government to reconsider its proposal to tax share options which are subject to forfeiture conditions prior to exercise.

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The Taxation Institute would be happy to meet to discuss these issues further. If you require any further information or assistance in respect of the Taxation Institute's submission, please contact the Taxation Institute's President, Joan Roberts on 03 9611 0178 or the Tax Counsel, Angie Ananda on 02 8223 0011.

Yours sincerely

Peter Murray